May 2007 • Issue 4, Vol. 5

The GovCon Report

# Timing is Everything
## Capital Investments and Cost Plus Contracts

*By Jim Hiles, Vice President of Contracts, MorganFranklin*

When is the best time to make a large capital investment?

**a)** When enough cash reserve or available credit has been accumulated to pay for the item
**b)** When someone else will pay for some or all of it

We all recognize that answer b) is way better than the first choice. Is having someone else pay for some or all of a large capital investment a pipe dream? Maybe it is, maybe it isn't.

A common concept encountered in government cost type contracts is the notion of cost sharing. This principle is normally encountered in incentive and award fee contracts where the contractor shares in either the financial reward of a cost underrun or the financial burden of a cost overrun. An example of the latter would be Fictional Company Q performing on a Cost Plus Fixed Fee contract that contained a 10 percent fee. The allowed cost ceiling for this contract is $900,000 plus a fixed fee of $90,000, or 10 percent. Company Q motors along doing work on this contract. Costs of $900,000 are accumulated, appropriately allocated and billed to the government on this contract, but the final deliverable is not completed. The government pays $990,000 to Company Q, representing the incurred costs and allowed fee. If Company Q agreed to a deliverable that has not been completed they are obligated to continue to work to complete the task. No fee is paid on costs incurred beyond the $900,000 mark. Company Q is paid for additional costs incurred but receives no more fee. Earnings on this task quickly erode. Government decisions normally made upon contractor notification that 75% of available funds have been incurred may change the outcome of this scenario by the government stopping continued performance, or agreeing to additional cost and fees, or some variation in between.

An incentive fee arrangement is another common example of cost sharing. Incentive fee arrangements are usually expressed with a ratio that describes the percentage of each party's share in either effective management that results in cost savings, or in a lack of oversight that results in a cost overrun. At the risk of oversimplifying this concept, an 85/15 share ratio means that for every dollar in cost saved, the government shares 15 cents of it with the contractor.

Football fans are known for applying gridiron analogies to non-football situations to simplify explanations or to make a point. A fine example of this is describing the post-proposal submission celebration of your capture team as premature with "they were excited for moving the ball down the field, but they weren't in the end-zone yet." What I would like to do here in a similar fashion is take the common use of cost sharing and apply it as an analogous framework for considering when to make capital investments.

Suppose that Company Q has a client base that includes a variety of government customers. Some prefer fixed price contracts, while others favor cost plus contracts. Company Q has a capital investment plan. It is a well thought-out plan featuring phased investments in technology and infrastructure that are tied to their strategic plans for growth. Projected revenue streams have been developed to quantify net present value and return on investment calculations for each large purchase. A common occurrence in this scenario, however, is a company-wide disregard for contract type during the possible times for making capital investments.

| | Responsibility for Cost | |
|---|---|---|
| | Government | Contractor |
| Cost Plus | 100 | |
| Fixed Price | | 100 |

Fig 1. Responsibility for allowable and allocable costs

Figure 1 displays the shouldered cost burden between the government and a contractor based on contract type. All costs allocable and allowable under a particular cost plus contract will be paid by the government. In a fixed price environment, the contractor has complete cost responsibility. The costs incurred to complete the fixed price contract do not factor in to what the contractor is paid by the government to complete the work.

For the purpose of factoring this into capital investment timing, Company Q decision-makers might only have to capture a picture of the depth and timelines of their cost plus contracts. Figure 2 is a hypothetical example of a Company Q chart of their contract base for several years. For ease of discussion, we will remove a level of complexity by disregarding the dollar magnitude of the contracts illustrated here.

| Year | 1 | | | | 2 | | | | 3 | | | | 4 | | | | 5 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Quarter | Q 1 | Q 2 | Q 3 | Q 4 | Q 1 | Q 2 | Q 3 | Q 4 | Q 1 | Q 2 | Q 3 | Q 4 | Q 1 | Q 2 | Q 3 | Q 4 | Q 1 | Q 2 | Q 3 | Q 4 |
| Cost Plus Contract 1 | CP | CP | CP | CP | CP | CP | CP | | | | | | | | | | | | | |
| Fixed price Contract | | | | FFP | FFP | FFP | FFP | FFP | FFP | FFP | FFP | | | | | | | | | |
| Cost Plus Contract 2 | | | | | | CP | CP | CP | CP | CP | CP | CP | CP | | | | | | | |
| Commercial Engagement | | | CE | CE | CE | CE | | | | | | | | CE | CE | | | | | |
| Cost Plus Contract 3 | | | | | | | CP | CP | CP | CP | CP | CP | CP | CP | CP | | | | | |
| Time and Materials Contract | | | | | TM | TM | TM | TM | TM | | | | | | | | | | | |
| Cost Plus Contract 4 | | | | | | | | CP | CP | CP | CP | CP | CP | CP | | | | | | |

Fig 2. Company Q Contract Timelines
Entries in blocks show when contract is active

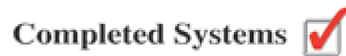
It appears that for Company Q, the prime time to make capital investments is between Year 2 Q3 and Year 4 Q1, since the increased depreciation will be billable to government contracts. Provided that the ceilings of these cost plus contracts have not been violated and the inclusion of the capital investment depreciation does not trigger an unacceptable price in the market, company management can rely on recovery of some or all of their investment by this government share of allowable and properly allocated costs.

While this is not the end-all for capital investment planning, it is an important consideration. If cost plus contracts are in your inventory, well-rounded capital investment decisions involve this type of thinking. Plunging ahead without such consideration is done at the risk of failing to consider the value of timing investments.

*Jim Hiles is Vice President of Contracts at MorganFranklin, a services and solutions provider to business and government on complex and high-stakes financial, operational and IT issues . He can be reached at (703) 564-7525 ext 249 or jim.hiles@morganfranklin.com.*

**Download this article in PDF format:**

The GovCon Report is produced by the Northern Virginia GovCon Council's communications committee: Co- chairs: Anne Crossman (Completed Systems) and Dave Lundsten (Cherry Bekaert & Holland LLP.) If you wish to submit an article for consideration by the communications committee, send them to govconarticle@fccc.org.




The Government Contractors Council Report is a monthly newsletter distributed by the Northern Virginia Government Contractors Council, an initiative of the Fairfax County Chamber of Commerce for Washington, DC metropolitan area government contractors.

**Fairfax County Chamber of Commerce**
8230 Old Courthouse Road Suite 350
Vienna, VA 22182
P: (703) 749-0400 • F: (703) 749-9075
**www.fccc.org**